Tom Alweendo: Prospects for a monetary union in the Southern African Development Community (SADC)

Address by Mr Tom Alweendo, Governor of the Bank of Namibia, at the Bank of Namibia's annual governor's address, Windhoek, 18 November 2004.

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Invited Guests,

Ladies and Gentlemen:

I am happy to welcome you once again at our annual event, where over the last five years I have shared my views on a number of issues of economic nature. This evening, I am going to share with you my views on the prospects for a monetary union in the Southern African Development Community (SADC). This topic is by no means new and it has been discussed by various speakers on various occasions. However, because of its importance it is worth repeating and hopefully we will start building a consensus around the issue.

The issue of monetary integration that is meant to ultimately lead to a monetary union on the African continent is being addressed at two levels. The first level of discussion is the continent-wide, where under the African Union the continent shall establish a common monetary policy and therefore a common central bank. The Association of African Central Banks (AACB) has been requested by the African Union to prepare the establishment of the African Central Bank and the time framework. The AACB has suggested a tentative work program that will see the African Central Bank being established by the year 2021.

The second level of discussion with regard to monetary integration is taking place at regional level, where all five African regions are expected to work on regional monetary integration. In the Southern African region, SADC is working on a program where we are going to establish a common central bank in the region by 2016 and a common currency by 2018. The year 2016 sounds far enough, but this is a mere twelve years from now.

Namibia's position with regard to a SADC monetary union is further complicated by our membership to the CMA. At the CMA level, we have also started with preliminary discussions that more and more points at the establishment of a CMA central bank ahead of the SADC central bank. An argument could be made that since all CMA member countries are members of SADC, it will be better for Namibia to concentrate on the SADC monetary union discussions. However, this will only be true if one was certain that the SADC discussions will go ahead as per the agreed timeframe. The concern here is that the CMA is a de facto monetary union, except that the function of making monetary decisions is exercised by one member country only. This is not an acceptable arrangement and we need to find a more equitable solution where decision making power is exercised by all member countries.

The decision to discuss the continental monetary integration issue at two levels was seen to be the only realistic strategy if we were to succeed. This is so because the continent is faced with diverse economic and social challenges and to try to discuss integration at continental level only will be foolhardy, at best.

Joining a monetary union will mean giving up your national currency and adopting a new currency or a currency of a larger country. To some people giving up your currency is a provocative notion that could be equated to treason. This is especially true for small, developing countries that might have just gained their political independence. The idea of being subsumed by a larger country is not appealing at all. Why, then, should a country want to enter into a monetary union?

The increased interest in monetary integration is closely linked to the process of globalization, especially financial globalization, which has been a dominant feature of discussions at various forums. In today's globalized financial markets, capital has become too mobile and cross-border investment too vast. Today world financial markets are too large, economies are closely integrated and financial technology too innovative.

In this context, the initiatives for free trade areas, customs unions and common markets are clearly designed as strategies of promoting a region within the global economy. Increasingly, the globalization process in terms of integrated markets is seen as a mechanism to enhance and promote the region's

competitiveness vis-à-vis other trading blocks and enlarged internal markets. The key elements of this process are the removal of the internal trade barriers and free flow of the factors of production especially labour and capital.

In a globalised financial market, the effectiveness of an independent monetary policy is questionable, especially for small open economies with one form or the other of fixed exchange rates arrangements. It is argued that it is very hard for a country to simultaneously maintain a fixed exchange rate and an open capital market while pursuing an independent monetary policy geared towards domestic economic policy. A country can opt not to be part of the financial globalization, except that the outcome will not be desirable. What is likely to happen is that such a country will be isolated and might become further marginalized in terms of its participation in the world economy. I must also hasten to add that while globalization is being portrayed as good for the world, it is also true that in itself globalization will not benefit those countries that are not prepared to take advantage of the new system.

In order to benefit from a globalised economy, I do recognize three issues that are of critical importance. First, a country needs to ensure that it has the necessary human skills capable of competing effectively within the world economy. Second, a country would need to have an institutional arrangement that conforms to international standards. Examples here are that your institutions must practice good governance; you must have an effective accounting regime; and you must have clear demarcation of functions and responsibilities among your institutions. The third issue I believe is important is an effective legal framework, where businesses and individuals alike are certain that their legal contracts are enforceable in a timely manner.

In our region, the increasing interest and momentum for the creation of a monetary union seems to revolve around two main considerations. The first is that the establishment of a monetary union in combination with free trade agreements is increasingly being seen as part of a strategic push to integrate the region. In this regard, a monetary union is seen as a way of reinforcing regional cohesion and demonstrating a commitment to regional solidarity. Indeed, the harmonization and unification of monetary policy represents the deepest form of economic and financial integration.

The second consideration for the formation of a monetary union is the desire to counteract perceived economic and political weakness which dates back to the period of colonial rules by putting in place regional institutions, of which a monetary union and common currency would be strong symbols. It would also appear that the launching of the European monetary union has influenced this process.

A strong argument and motivation for a monetary union is that it brings a number of benefits. The most often cited benefits are the increased intra trade, price stability, increased aggregate investment, and the elimination of the exchange rate risk. It is argued that the elimination of the exchange rate risk would allow for increased capital inflow and regional investment opportunities resulting in welfare gains and growth. It also reduces transaction cost within the region incurred when changing one currency to another.

Besides increased intra-trade, economic theory and experience also suggest that a single regional currency is expected to have a more stable internal and external value. Therefore, the benefits of price stability and monetary policy credibility are more likely to be realized in a monetary union. This is especially true if the regional monetary authority is autonomous in carrying out its functions and where its primary objective is price stability.

It is also suggested that a monetary union would improve macroeconomic stability by ensuring fiscal and monetary policy credibility. This is necessary for attraction of investments, which eventually translates into economic growth as potential investors would only invest if they have full confidence that they would get sufficient returns on their investments.

There are also costs involved in participating in a monetary union. By far the most often talked about cost, is the loss of autonomy to manage monetary policy. Arguably, national autonomy over monetary policy is supposed to give a country the maximum freedom and flexibility, through the use of various monetary instruments such as interest rates and reserve requirements, to steer the economy in a particular direction. Given that monetary policy is a key instrument of macroeconomic management, the constraints imposed by a monetary union on the pursuit of country specific objectives may therefore be viewed as constituting a hindrance to achieve country specific economic goals. This point is important especially for SADC countries that are at different stages of development and with different degree of financial and economic structures. Such diversity would make it difficult to sustain a monetary union. Therefore, having a unitary monetary policy for the region would be a daunting task

especially given the fact that our countries have different shocks that may require different policy responses.

Yet, financial globalization has taught us that the use of an independent monetary policy is severely limited. With globalization, cross-border capital flow is inevitable and this makes independent monetary policy ineffective especially for small developing countries. The logical conclusion is that such countries will be better-off with a monetary union since they cannot, in any case, effectively implement independent monetary policy.

Another cost associated with monetary union is that the ability of the government to conduct fiscal policy is constrained by the limits collectively agreed and imposed in respect of budget deficit financing. The imposition of limits on deficit financing is necessitated by the desire to prevent member states to run large unsustainable deficits that could put upward pressure on interest rates and exchange rates in the entire monetary union area. I would, however, want to believe that the restriction on deficit financing is a benefit and not a cost, because it encourages prudence in fiscal management.

A monetary union will be more feasible among countries with open economies and strong trade links with each other. Furthermore, a monetary union is likely to be successful if there is a significant degree of economic convergence among the member countries in respect of some of the macroeconomic variables. In the SADC region, empirical data indicates that the region does not meet all the criteria suggested by the optimum currency area theory, neither is there convergence in most of the economic variables. The process to establish a SADC monetary union will therefore be long because of the macroeconomic convergence that must be established first.

The lack of convergence in key macroeconomic variables may suggest that the region is not yet ready for a common currency. However, I must add that it may not be crucial to meet all the criteria prior to the formation of a union. It is possible for member countries to agree to meet some of the criteria only after the formation of the monetary union. Experience has also taught us that in the case of the European Union, it was not only the economic argument that was the defining factor in the formation of the monetary union, but also the political drive for unification. It is therefore important to have political champions to promote the cause for a SADC monetary union. In the European example, Germany and France were the political champions for their monetary integration.

Let me conclude by saying that, in general a monetary union is desirable as it is likely to promote macro-economic stability and economic growth among member states. However, a monetary union should not be seen as an end in itself but as part of a process for wider economic integration in the region. To ensure a successful implementation of a SADC monetary union within the agreed timeframe, it is important that member countries intensify and redouble their efforts towards the realization of this noble objective. In particular, member countries would need to pursue appropriate policy measures in order to satisfy the convergence criteria. Given the importance of the issue and the sensitivities around it, it is crucial that the citizens of the member countries are properly informed of the desirability of a monetary union.

A SADC monetary union will also have its unique challenges. Member countries should therefore prepare themselves if they were to optimally benefit from the new arrangement. For example, member countries would need to strategically position themselves such that they increase their share of intra trade and investment within SADC and beyond. In the case of Namibia, we need to continue with the diversification of the economy towards manufacturing and services. We also need to do more in terms of concrete action plans to develop our human capital. This is a vital area where a lot has been said so far, but there is little evidence that suggests that we are succeeding in building human capital that is ready to compete effectively in the global economy.

Thank you for your attention.